RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Dec. 2, 1998 **LETTER 1266**

THE PICTURE: November 23 saw the Dow surge over its previous record high of 9337.97 to close at a new all-time high. Does this signal a new bull market or even a continuation of the "old" bull market? Not according to Dow Theory. Dow Theory states that only penetrations of previous points by **both** the D-J Industrials and the Transports can be taken as valid indications.

No question, the Industrial performance has been powerful, even sensational. But the Transports have, unfortunately, lagged far behind. Why the continuing poor performance by the Transports? Why haven't the Transports been able to better their record April high of 3686.02 recorded seven months ago? Why have the Transports failed even to better their July high of 3618.33 recorded four months ago? I can guess, I can theorize, but I can't really give you the authoritative answer. It's enough, from a Dow Theory standpoint, simply to realize that the Transports have not confirmed and are still very far from confirming.

Yes, the Transports may confirm in a week or a month or a few months -- it's certainly possible. But history is filled with instances where one Average has failed to confirm the indication of the other, and the aftermath has been anything but pleasant. The latest example, of course, was back in July when the Transports refused to confirm the new record high in the Dow. The aftermath was the July-October collapse.

My PTI (page 2 chart) tells us that the trend is up, and traders and speculators are certainly free to follow the PTI. But Dow Theorists, for reasons of extreme market overvaluation plus the flagrant non-confirmation in the Averages, will step aside and simply "let the good times roll."

THE STORY: What's the story nobody wants to talk about? It's basic, it's fundamental, and there's no easy way around it. The story is **world over-capacity.** The world today is producing **too much** -- too much oil, too many cars, too much corn and wheat, too many textiles, too many computers, too much and too many of almost everything. Listen to this from Charles Clough, chief strategist at Merrill Lynch: "Immense amounts of capital have been available in the last few years. American businesses became more efficient and generated huge amounts of free cash. They used that cash to finance one of the greatest investment booms ever. Investment grew 70% faster than final sales over the past three years; it has been the engine that has produced jobs and growth.

"There is a downside, however. Investment increased production capacity, and now excess supplies are proliferating.

Nov. 20 DJIA 9159.55; PTI 5328; A-D Ratio +5.74
Nov. 27 DJIA 9333.08; PTI 5346; A-D Ratio +5.98
Dow Yield: 1.63%; Dow Price/Earnings: 25.1
Dow 144-day MA: 8642; Dow 34-day MA: 8752
Dow Times Book Value: 5.85; PTI 89-day MA: 5298
Percentage of Undervalued Blue-chips: 4%
Gold 34-day MA: 296

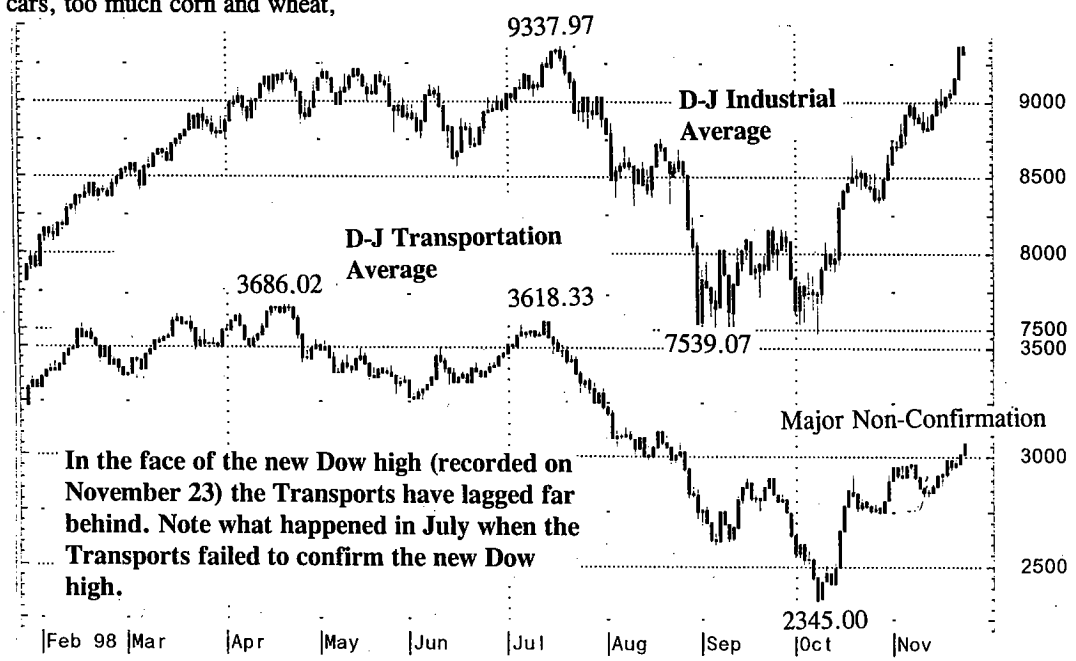
More than 20 new models of the ubiquitous sports utility vehicle were introduced in 1998, for example. Retailers and financial institutions have added capacity faster than Americans can either spend or save . . . Industrial production rose 25% in the last five years, yet the percentage of manufacturing capacity that is actually being used is flat."

That, in a nutshell, is the real story. With China producing at half capacity, with most of Asia in a recession/depression and producing at a fraction of their capacity, in the face of this abbreviated production, goods continue to flood the economies of the world. There just isn't a need or a market for all these goods and materials.

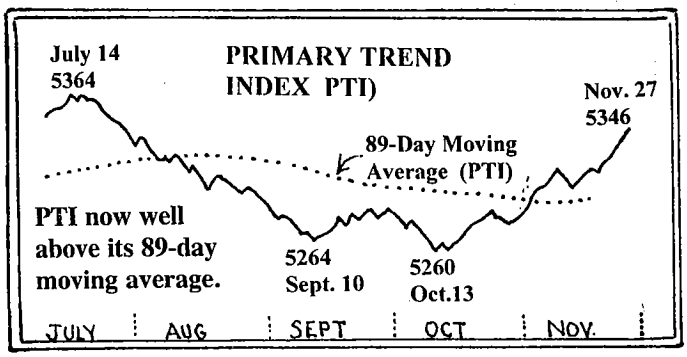
So a squeeze is developing. It's a wage/price squeeze. Wages in the US are rising at a 4.0% rate (year-over-year), but at the same time there's simply no pricing power, meaning that corporations, because of vicious competition and over-production, are unable to raise prices. The result -- a coming squeeze on corporate earnings.

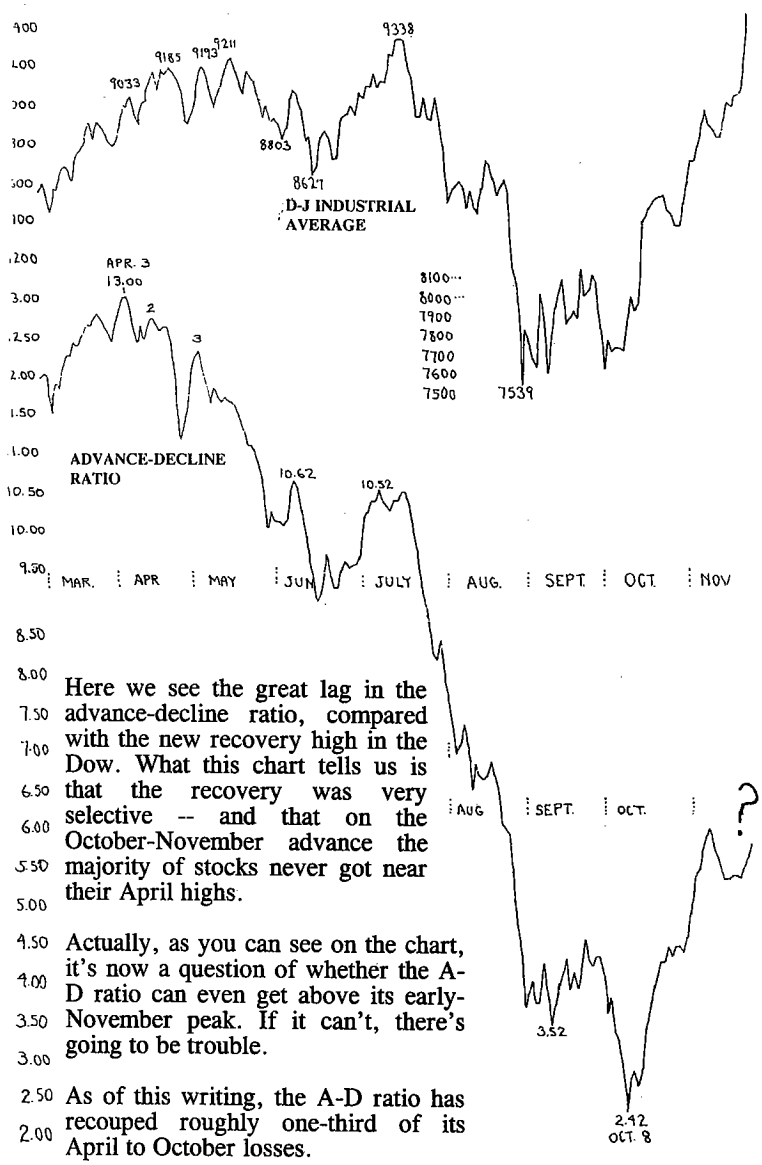
MORE ON THE MARKET: Months ago I stated that when the bear market arrives the government and the Fed will fight the bear "tooth and nail," fight the bear with all the ammunition and money and "talk-power" at their command. And that's exactly what's been happening.

Consider this: In December 1996, with the Dow at 6500, Fed Chairman Greenspan warned investors of "irrational exuberance." Now, with the Dow almost 2900 points higher, not



In the face of the new Dow high (recorded on November 23) the Transports have lagged far behind. Note what happened in July when the Transports failed to confirm the new Dow high.





Here we see the great lag in the advance-decline ratio, compared with the new recovery high in the Dow. What this chart tells us is that the recovery was very selective -- and that on the October-November advance the majority of stocks never got near their April highs.

Actually, as you can see on the chart, it's now a question of whether the A-D ratio can even get above its early-November peak. If it can't, there's going to be trouble.

As of this writing, the A-D ratio has recouped roughly one-third of its April to October losses.

only has Greenspan ignored the much higher Dow, but the Fed has been firing up the economy and the market by cutting Fed funds three times and the discount rate twice, all this within a matter of a few months. So much for irrational exuberance when the big bear threatens.

On top of this the US is now playing central banker to the world, tossing billions of dollars at various troubled nations while providing additional billions to the IMF. What does it all mean? The Fed, the Treasury and the Administration have decided that they will not only fight the bear, they have decided that they can beat the bear.

So here's the BIG PICTURE. The world is faced with over-capacity, **over-production** of almost every brand and variety of goods. To counter-act this, to fight this, the US (and most developed nations) are flooding the markets with **liquidity** (refer to the MZM chart in the last Letter). This liquidity has to go somewhere, and where it's been going is **into the stock market.**

So ignoring world over-production, ignoring a trend of declining earnings, ignoring sky-high price/earnings ratios, ignoring almost non-existent yields, stocks have been rising on a flood of Fed-produced liquidity. How long can it last? The Russell guess -- maybe through December, but I suspect trouble will hit in January.

PRIMARY TREND INDEX (PTI): The PTI bottomed during mid-October, then turned sharply higher. On October 30 the PTI turned bullish as it rallied above its 89-day moving average (see Letter 1264, page 2). For those who trade on the trend of the PTI, this was a clear "buy signal." But for those who trade or invest based on the Dow Theory and values, this was an interesting signal but NOT one they were willing to move on. The PTI rose in the five-wave series, then halted at 5346. With the Dow at a new high, note that PTI has not yet confirmed by rising to a new high of its own. In fact, it may be significant that the PTI halted 18 points under its July 14 high of 5364, then turned down on Nov. 30.

DOW THEORY: On August 4, 1998, a primary bear market was signaled under Dow Theory. I said at the time, and I have repeated, that we should expect a deceptive, tortuous and extended bear market in which the bear would be locked in a death struggle with the various governmental authorities and agencies. I even likened the picture to the confusing, hair-pulling series of advances and declines that characterized market action during 1966 to 1974. I don't think this bear market is going to occupy anywhere near as much time as the 1966-'74 configurations, but I do think that this bear market is fated to be just as confusing and deceptive.

I continue to believe that the August 4 bear market signal was valid, and that what we've seen over the last few months was a spectacular bear market rally, a rally "fired up" by Fed action to lower interest rates plus a massive increase in the money supply. Furthermore, the advance-decline ratio, which is a proxy for ALL the stocks on the NYSE, has only recovered 35% of its April to October losses (see page 2 chart).

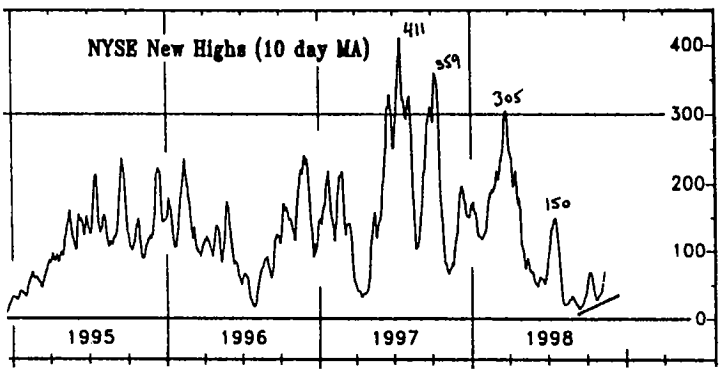
THE RALLY: There are, in my opinion, three factors behind the market's extraordinary advance. **(1)** The continuing, often frenzied, buying by the public via index funds, mutual funds and individual stocks. The wild bidding-up of the various Internet stocks added excitement and impetus to the recovery rally.

(2) A second factor is the absolute explosion in the money supply with MZM (money of zero maturity, equal to spendable cash) roaring up at a rate (latest four weeks) approaching an incredible 25%. This is the greatest surge in the money supply that I can remember.

(3) A third factor behind the market's advance is something that I've called attention to over recent months. It's this nutty business of quarterly earnings "beating analyst's expectations." Now *Business Week* has finally exposed this nonsense. It seems that many corporations purposely down-play their quarterly earnings prior to their actual release. Then the corporation releases actual quarterly earnings, and surprise -- earnings have "beat expectations." So traders rush in to buy the stock. The stock pushes up, even though, on a comparison with the same quarter a year ago, earnings may be down. It's ridiculous, but it's this year's phony game. The

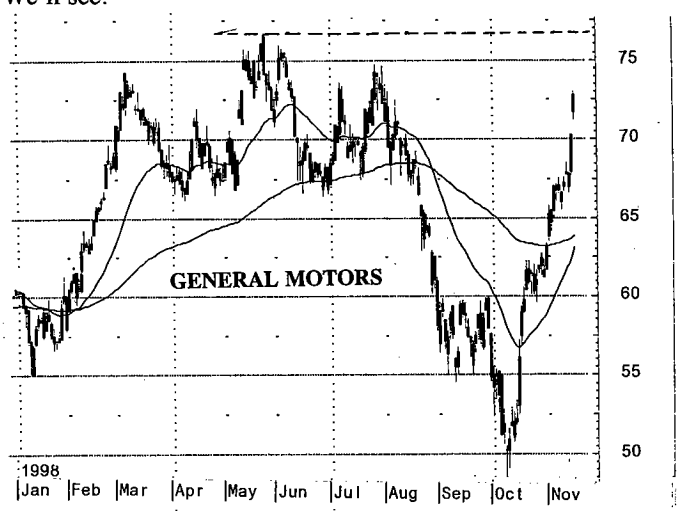
fact is that corporate profits dropped 4% in the third quarter according to *Business Week's* calculations. But the quarterly earnings expectation nonsense goes on.

New Highs: One interesting facet of this rally has been the dramatic dearth of daily new highs This chart [courtesy of *Topline Investment Graphics* -- (303)440-0157] shows the collapse of daily new highs during the rally. Of course, the lack of new highs is a function of the lagging advance-decline ratio. The fact is that a majority of stocks have lagged the leaders, and if the majority of stocks don't "move up and out" you're not going to see a lot of new highs.



Cycles and Stuff: Going back to 1940, every mid-term election has been followed by a market advance over the next year. A lot of periodicity-believers are betting that 1999 will be no different. It may work again, but I would suggest just following the PTI instead.

Now here's an interesting test. The old "rule" (put forth, I believe, by analyst Robert Stovall) ran this way: "The stock market is in a sell mode if six months go by without a new high in General Motors." That observation used to have a wide following. GM hit a high of 76 11/16 on May 26. Six months have now elapsed without a new GM high. A valid sell signal? We'll see.



A few words about cycles and periodicity. There's little question that in studying history, the same phenomena occur again and again. The big question that I ask, however, is do these phenomena occur with any kind of real periodicity? For instance, I know that the market will rally and the market will decline. You can call these the cycles of advance and decline. But is there any periodicity in these moves or are they totally random? My own experience is that the longer a series goes on, the **greater the odds that the series is due to malfunction.** If that was not so, market trading could be reduced to a mechanical formula. If there is a formula, nobody has discovered the formula yet.

INVESTMENT POSITION: I've been studying the November 13 issue of the *Value Line Investment Survey*. This outfit has a good record as a stock picker. The *Survey* offers three portfolios, one with "stocks above-average year ahead price potential," a second one with "stocks for income and potential price appreciation," and the third, "stocks with long-term price growth potential." There are about 60 stocks total on the three lists. All are in their 1, 2 or 3 categories for timeliness, which means that *Value Line* likes them for buying (at least likes them compared to the rest of the stocks on the various markets).

What I noted, however, was that of the 20 stocks for above-average year-ahead price potential, 7 had yields below 1% and 12 had no yields at all. Of the 20 stocks for income, 2 had yields over 5%, 1 was over 4% and the rest yielded 3% or below. For the list with long-term growth, 9 had zero yield, 1 had a 2% yield and the rest had yields below 1%.

Frankly, these are stocks that I would **not** buy. I just will not buy a collection of stocks with negligible or zero yields. What happens if the market hits the skids? Would I be willing to sit with a pack of stocks that throw off no dividends? I would not. No, I'm a patient guy. So I'll just wait for the time when stocks provide juicy yields again. It may be a few months, it may be a few years. I'll wait. In my experience, yield-less stocks end up as losers; it's been that way ever since they began trading stocks under the Wall Street trees, and I believe it will continue that way.

The only thing that changes is the timing. And with the Fed and the Administration fighting the bear, the timing will be **extended. And the action will be deceptive.** But as I said, I'm a patient guy.

Incidentally, the widely-followed S&P 500 now sells for 29.58 times earnings while offering a dividend yield of 1.4%. This is an astoundingly high valuation, one that I've never seen before, and, I believe, the highest in history. This means you are paying $72 for every one dollar in S&P dividends. Against this, you now pay $19 for every dollar of interest from long-term Treasury bonds. This ratio of 3.78 in favor of bonds is mind-boggling -- and dangerous.

At this juncture you can say that never before in history has confidence in stocks been this high -- never. Of course, you can also say that never before has the market been this unprepared for a shock or a disappointment.

NOTES & QUOTES: I listened to almost all of Ken Starr's long introduction to the impeachment process. I thought Starr was terrific and that he presented an absolutely iron-clad case for the impeachment of Clinton. The Constitution talks about "high crimes and misdemeanors" as grounds for impeachment. Clinton committed not only misdemeanors but felonies. Felonies by the nation's leader, a man who had sworn to uphold the law -- how could he not be impeached? The answer, cowardly politicians who sense that the public doesn't want Clinton impeached, so instead of upholding the law, these politicians are upholding the odds of their being re-elected. Ugh.

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Last week I spoke to my sister on the phone; she lives in Greenwich, Connecticut, which is really a suburb of NYC. Kate told me that she and her husband went to the city, and she had never seen it so crowded. "New York is just totally clogged-

up," she added, "millions of tourists and just too many New Yorkers." I answered, "Well, you can always do what I do. I subscribe to the *New York Times*, the *New York Observer*, *Time Out New York*, *New York* magazine and that unofficial defender of Clinton, the *New Yorker* magazine. I can sit out here in the sun and read all about New York without the damnable inconvenience of living there."

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And speaking of the *New Yorker* magazine, the November 23 issue features an article about JP Morgan's bailout of the nation's banks and economy in 1907. Morgan prior to 1907 had acted as the nation's unofficial central bank. During the Panic of 1907 Morgan got the banks to put up millions and according to Wall Street annals, Morgan saved the nation. The *New Yorker* likens the Fed's 1998 rescue action on Long Term Capital Management to Morgan's action during 1907. Of course, Morgan's action was confined to the US. Today, the Fed acts as central banker not only to the US but to the world.

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Everything happening on Wall Street today appears (at least to me) to be a function of **soaring liquidity.** Consider this: at the height of the art boom in 1989 an excellent self-portrait by Van Gogh sold for a fat $24 million. But a few weeks ago on November 19 another Van Gogh self-portrait sold for a staggering **$71 million.** Christie's had estimated (because the painting was rather small, only 16" by 12", and based on the '89 sale) that the Van Gogh would go for $20 to $25 million. Liquidity, liquidity.

When you think about it, that was a huge price to pay for any painting. That same $71 million invested in Treasury bonds would throw off $3.7 million a year in interest or over $10,000 a day. When you figure the added cost of insurance on the painting, you're talking about an almost obscene amount of greenbacks for the pleasure of owning that painting. Ironically, Van Gogh sold only one painting in his life, and that one he sold to his brother. Of course, 20 years from now a dollar may be worth about a dime and that Van Gogh will still be a treasure.

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The Net seems fated to take over the world as we know it. Whose running these Net stocks wild? According to the *WSJ*, it's the little guys, the odd-lot Net traders who are doing it. But what does it matter? Net stocks, any stock with a **.com** in its name, are running wild. Listen to this from the latest *Fortune* magazine (Dec. 7), "Somewhere out there is a bullet with your company's name on it. Somewhere out there is a competitor, unborn, unknown, that will render your business model obsolete. Bill Gates knows that. When he says that 'Microsoft is always two years away from failure,' he knows that competition today is not between products, it's between business models . . . The hottest and most dangerous new business models out there are on the Web . . . OK, so the Web has been hyped to the point of absurdity by fanatical true believers, but when you strip away the frenzied predictions of the digerati, you're still left with an inescapable fact: the Internet will change the relationship between consumers and producers in ways more profound than you can yet imagine. The Internet is not just another marketing channel; it's not just another advertising medium; it is not just a way to speed up transactions. The Internet is the foundation of a new industrial order.

"The Internet will empower consumers like nothing else ever has. Think about this. Already 16% of car buyers shop online before showing up at a dealership, and they're arming themselves with information on dealers' costs. So forget all the patronizing nonsense about being market-led or consumer-focused. The new reality is **consumer-control,** and it's as ominous as it sounds if you're not prepared for this radically different future. Indeed, the Internet represents the ultimate triumph of consumerism. Sure you know the Internet is going to be important, but if you don't have a deep visceral sense of how radically it's going to change today's industrial order, you lose."

Russell Comment: Three things: first, I agree with all the above. But I believe, as I have said many times before, that by its very nature the Net is going to be **hostile to profits.** Give the consumer a huge amount of information, give him your costs, give him the price list of your competitor, and you're going to be dealing with very tough consumers -- and super-competitive markets. **Item:** GM expects to generate new business via the new "GM Buy Power" feature on its Web site, which allows shoppers to order vehicles electronically and simply visit the showroom to pick them up.

Two: Competing on the net is not like competing in the auto business or the steel business. Two brilliant kids out of Berkeley or Stanford or Harvard with a garage for a lab can get on the Web with a new idea and raise hell with any business or any industry. Gates is right when he says that Microsoft is always two years away from failure. He knows that there are a lot of brilliant kids out there, and they're gunning for Microsoft's business. They're gunning for everyone's business. Believe it. And it doesn't take a billion dollars to do it, it just takes brains and ambition.

Third: Business on the Web can change fast. A Net company is a winner today. Then another outfit gets on the Net and competes. Then a third and a fourth company comes on. And before you know it the stock that ran from 20 to 250 and then split three for one, that stock is suddenly running into vicious competition (watch Dell, for instance), and in a week everything changes.

So what are we dealing with? We're dealing with **a revolutionary new universe** based on brains and ambition. And oh yes, consider this -- who else has the energy and drive of two 25-year-old geniuses who want to make their mark in the world? The Net -- turning the world upside down, but -- by its nature hostile to profits -- a boon for consumers.

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The public may love Clinton, but the Washington establishment does not. In a recent article in the *Washington Times,* the story is told, and I'll include a few quotes. "With some exceptions, the Washington Establishment is outraged by the president's behavior in the Monica Lewinsky scandal. The polls show that the majority of Americans do not share that outrage." "'He came in here, and he trashed the place,' says *Washington Post* columnist David Broder, 'and it's not his place.'" "'People felt a reverent attitude towards 1600 Pennsylvania Avenue,' says Tish Baldrige, who once worked there as Jacqueline Kennedy's social secretary and has been a frequent visitor since. 'Now it's gone, now it's sleaze and dirt. We all feel terribly let down. It's very emotional. We want there to be standards. When you think back to other presidents, they all had a lot of class. That's non-existent now. It's sad for the people in the White House. I've never seen such bad morale in my life. They're not proud of their chief.'" "Establishment Washington reveres the office of the presidency. If Washington is a tribe, then the president is the tribal chief. He cannot be seen to dishonor the tribe." "Even those who have to deal with or publicly support the administration do so grudgingly. They say that regardless of whether his fortunes improve, Clinton has essentially lost the Washington Establishment for good."

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Already market historians are wondering whether the current buying explosion in Internet stocks will go down in the books as a **mania.** The Russell opinion -- yes, it is a mania. Here are a few other market manias. Tulips in the Netherlands, 1636-'40. British government debt, Amsterdam, 1763. Canals, Britain, 1820s and in France, 1823. Rail shares, US, 1857 and 1873. Public lands, US, 1836 and 1847. Building sites, Florida, 1925. Gold, worldwide, 1979-'80.

Case in point: K-Tel International, Inc., the music retailing outfit. The company had traded for years on the Nasdaq at less than $4 per share. Then, on April 9 someone at K-Tel put out a

press release saying the company was planning to open a retailing site on the Web. Within a month, K-Tel was selling for nearly 40. But more recently, K-Tel collapsed when it was de-listed on the Nasdaq. Reason, insufficient capital. The company may have less than a million dollars in actual capital.

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The estimate is that over 100,000 people are now day-traders, and for day-trading most use the Net. The reasons for the surge in day-trading, I believe are (1) the very low commissions charged by a number of Net brokerage firms ($12 for up to 500 shares, and in some cases even lower), and (2) the huge amount of technical and fundamental information, most of it free, now being offered on the Net. "Hey, I can sit here and trade along with the pros. It's fun, it's better than gambling, and it's a hell of a lot better than working." Yeah, right.

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This year, 1998, is shaping up as the biggest year in corporate layoff announcements in a decade. And '99 looks as though it will be even worse. In four recent days Texaco announced layoffs of 1,000, AmeriTruck of 1,000, Eastman Kodak of 300, Montsanto up to 1,000, HJ Heinz of 400, JP Morgan of 700, and Callaway Golf of 700. What's happening? With wages now pushing up but with prices flat or actually being squeezed, corporations are faced with cutting expenses or dealing with falling profits. The answer -- cut expenses. With many corporations having already cut expenses, there's only one way left -- pink slips.

* *

The following from my old friend, Burt Dohmen of the *Wellington Letter* [(808)545-2243]: "The wealth destruction, caused by the policy of errors of the central bankers over the past year, has been horrendous. Injecting $100 billion or more into the world financial system does not compensate for several trillion dollars of wealth being wiped out. Asia is still in a virtual depression, China is in a precarious economic situation, and Japan, of course, has been in a deflationary spiral, which we may start seeing bottoming next year. But there's nothing that would produce a return to robust economic growth. In fact, next year US manufacturers will be hit hard by cheap Asian imports, once the emerging Asian countries start producing again. Because of their much lower currency values at this time, their goods will be extraordinarily cheap."

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The three smartest women in the world are Maureen Dowd, Peggy Noonan and er -- my wife. In *Forbes* magazine's ASAP Peggy Noonan writes about the concept of time. She notes that the more civilization progresses, the less time it seems we have to -- well, to just relax and enjoy life. I agree. It seems everyone is rushing around trying to make a buck, most women are now working, men are working longer hours, rush, rush, buy a car, buy a summer home, buy a $125 dinner, work your fannie off for a two-week vacation, but what about smelling the roses? What? This year you didn't have time to plant any darn roses? Ah well, it's late, why not just try to grab a few hours of sleep.

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By the way, the brilliant Peggy Noonan admits that for relaxation she reads both the tabloids, *The Enquirer* and *Star*. Blush, so do I. By the way, if you're ever envious of the rich and famous, read either of these. Diseases, divorces, sex scandals, crime, it's all here, and most of it seems to happen to the luckless, hapless rich and famous. Nah, I don't envy them.

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I just read an article about Theresa Bernstein of Gloucester, Mass. Ms. Bernstein is an artist, has been an artist for a long time, actually since 1900, and she now gives lectures on art. This wouldn't be too unusual except that Ms. Bernstein is 108 years of age. Earlier this year, a New York gallery gave a retrospective of her work . . . I just bought a painting by Harry Sternberg, an artist who lives in Escondido, about 25 miles from here. Harry is nationally-known, and he's had exhibitions in many cities. Harry paints every day. He's 94 years of age . . . Then there's my mother's childhood friend, Amy Snyder. She's now 104. Amy used to play a lot of tennis, which is maybe why she's still around today. She does complain about back pains. However, I think in all three cases good genes are the main reason for their longevity. I also think a real interest in life, in doing something you love, is a reason for longevity.

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As the season of the new currency, the euro, draws closer, the European nations' jealousy (or anger) at the US is surfacing. Whereas the US and Europe were supposed to get together and solve problems, it seems that recriminations and threats have been the order of the day. In fact, two weeks ago threats of a trade war arose when the US accused Europeans of shirking their "responsibilities" in supporting the various troubled nations.

Nerves are taut as leaders hint at an EU-US trade war

Washington's irritation is growing, reports **Guy de Jonquières**

When more than 120 business leaders and top officials from the US to revert to protectionism. This year's global financial crisis would become ing's closing ceremony – was thought by some to be both ill-timed and politically

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Ed Hyman, Wall Street's and my favorite economist, is hardly hopeful regarding South America. In his November mailing, Ed writes, "Latin America collapse likely. Under the weight of a severe fiscal drag package, combined with 42% interest rates in the face of only 3% inflation, and a stock market that has been cut in half, Brazil's economy, which is already in recession (industrial production is down -6% year-to-year, retail sales -11%, and layoffs are intensifying) will probably contract at a -30% annual rate, similar to Indonesia. Just as the Pac Rim crisis had a ripple effect, so will Brazil's. Argentina and Mexico are already slowing."

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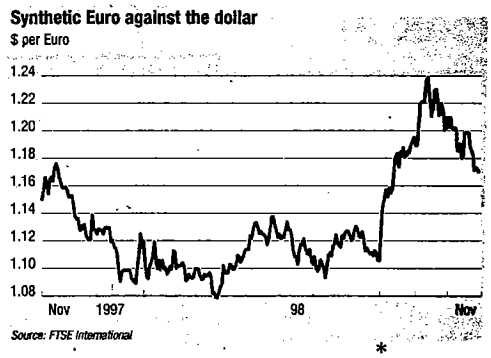
Japan, China, Hong Kong, Taiwan and other economies in Southeast Asia are financing America's huge current account deficits. Which means that Asia buys a mountain of US bonds. Asia holds a combined 40.5% of the world's foreign-currency reserves and the big question is how much of these reserves will be switched into euros next year. This will tell us how strong the dollar is fated to be as against the euro. But aside from any talk or any predictions, we already have the synthetic euro in action, and this chart from the *Financial Times* shows the euro surging, but more recently looking just a bit toppy against the dollar. The US has a 21% share of the world's economy, but the US dollar makes up 56.4% of international reserves. There are big stakes here. If the euro turns very strong against the dollar, central banks will be big sellers of dollars and dollar assets, and they will be big buyers of euro bonds. Should be interesting, and I'm watching that synthetic euro. Remember, on January 1, the euro comes into being.



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What's Saddam's real goal? It's to be the leader of the Arab world. And Saddam sees it, his political survival depends on his possession of weapons of mass destruction. To hang on to those weapons, this ruthless killer has sacrificed more the $120 billion in oil revenues and endured a brutal seven-year embargo. His intelligence service has played an endless game of cat and mouse with UN inspectors. So far, Saddam has been able to keep a large amount of his weaponry hidden. Meanwhile, US presidents

have continued to play the game of trying to "box in" Saddam. It won't work. Ultimately, either Saddam will make his military move, the US will give up trying to contain or overthrow Saddam -- or, the US will finally have to use its military. Clinton, I believe, is hoping to keep the status quo until he gets out of office, and in so doing, handing the problem to the next president. Saddam obviously knows this and is using it to his advantage.

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Daimler and Chrysler. It really wasn't a merger, it was a Daimler takeover of Chrysler. What happens next? Chrysler has been a money-making machine, turning out cars for cheap. About 177,000 of Daimler's 320,000 employees turn out 1.2 million cars a year. Chrysler's 110,000 employees produce about 3 million vehicles a year. The future? Said one expert, "Some Daimler guys are going to have to go over and show Chrysler how to make cars." Another said the Chrysler cost-cutters are going to have to show Daimler how to cut production fat and trim the bottom line. Problem -- putting anything like Daimler advanced technology into Chrysler cars would result in over-engineered economy cars that no American can afford. But my bet is that Daimler engineers are going to exert a very positive effect on Chrysler cars.

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Here's a strange one, a warning from (of all people) Michael Eisner, CEO of ever-optimistic Disney. Last week, before an audience of academics and managers in Beverly Hills, Eisner said, "My guts tell me it can't last forever . . . The gold rush is 80% false gold." He added, "Economic slumps are due for a big come-back," and many of today's managers have had no experience in dealing with such events. Although Eisner said he was not proclaiming imminent catastrophe, he referred repeatedly to the early years of the next decade in cautious terms. He felt "somewhat intimidated" as the millennium approaches. Eisner said he was particularly wary of the challenges posed by the new technology and he added that it was "distressingly easy" for the most astute managers to make the wrong decisions."

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Will China devalue? The pressure is on. Deflation coupled with slower economic growth is a growing problem. October saw a 2.9% drop in prices, the 13th consecutive month of decline. Cheap imports from other Asia nations are hitting the shores of China, adding to deflationary pressures. Another problem is simply over-capacity. For instance, with more than 100 producers of cars scattered across the country, China has capacity estimated to be twice this year's output of 1.6 million cars. In an effort to ward off trouble, Beijing has set minimum selling prices on 21 industries ranging from sugar to glass to TV sets. It won't work.

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The Las Vegas stocks, Circus Circus, Mirage, MGM Grand have all been smashed. The dismal stock action doesn't bode well for Vegas. What could be the matter? Too much building, too many casinos, and 20,000 more rooms coming in future construction.

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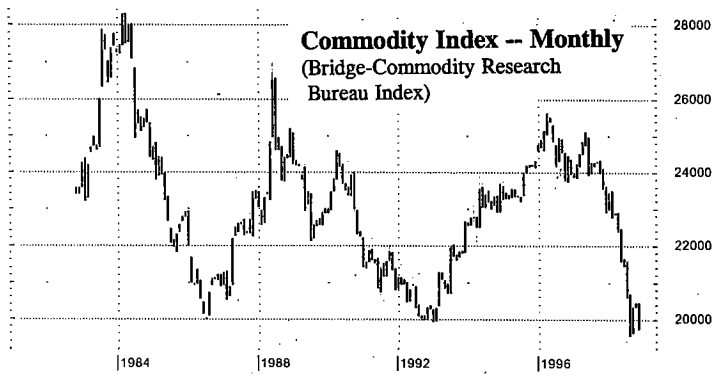
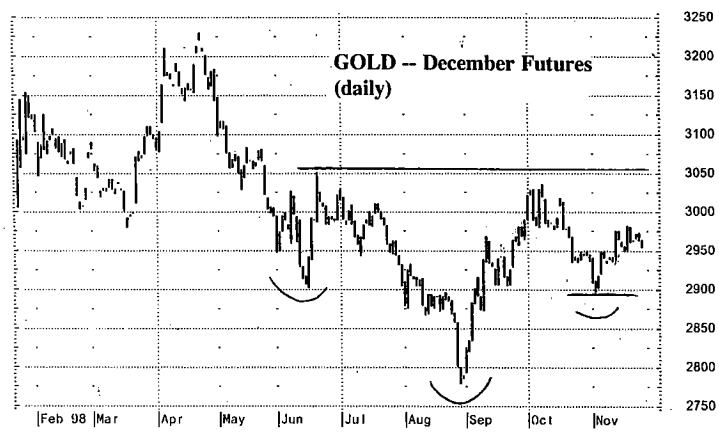
London's *Economist* magazine is very skeptical of the Fed rate cuts. They ask, "So what is wrong with America's cutting rates now just in case? Plenty. Every rate-cut pumps up an already inflated stock market. Investors pile in more money in the conviction that the Fed will bail them out if prices start to fall. Rising share prices, in turn, allow consumers to carry on spending, and companies to keep investing. But the more share prices become overvalued, the more they will eventually have to fall. And the more consumers have spent and companies have invested on the basis of these overvalued prices, the more painful the economy's eventual adjustment will be. The Fed failed to prick the bubble before it grew too big by raising rates a few years ago. It may now regret that; and it may come to regret cutting rates now."

Russell Comment: The money supply continues to rocket higher. M-2 money supply growth is now rising at a 14.5% annual rate. In the last four weeks M-2 has added $57 billion to the money supply. The broad M-3 money supply has added half a trillion dollars over the past year. So far, most of this money seems to have moved into one area -- the stock market. On top of that, consumers' savings have gone negative as they dip into savings or assets in the wild spending boom. Sooner or later this monetary explosion has to show in the inflation figures. I'm watching the bonds -- the key level in the bond futures is 125. Below that the bonds turn bearish. I'm watching gold -- above 306 gold turns bullish. I'm watching the Dow -- below 8800 and the Dow turns bearish. I'm watching the S&P 500 -- below 1115 and there's trouble. In the meantime, the commodity indices flirt with 20-year lows. What's the answer, why isn't the huge expansion of the money supply showing up in the inflation items? Answer: The forces of deflation (due to over-capacity) are so strong that all the surging money supply does is keep the system from tanking. Will the Fed keep pumping until signs of inflation appear? We don't know, but we do know that changes in the money supply usually take about a year to show up in the economy. Here's an interesting one -- after three cuts in the Fed Funds rate, after two cuts in the discount rate, the long bond is still well below its October 5 high of 134 22/32nds. Why haven't the bonds surged to new highs? Answer: Bond traders are hesitant; they're protecting themselves against possible inflation ahead.



GOLD: With the money supply heading skyward, you'd think gold would be turning bullish. Not yet. The chart is particularly interesting. What we see here is a potential "head-and-shoulders" bottom. But to complete the bottom, gold would have to move out above 306. Not yet. On the other hand, if gold breaks below 290 it would appear very weak. Right now, gold is in no-man's land, well above its August low but also well below its October high. It's clear that the worldwide forces of deflation have put a lid on gold, at least so far. Will the galloping money supply drive gold above 306? Or will deflation win out? Greenspan is probably wondering the same thing. You, I and Greenspan will have to wait in order to find out.



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